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Correspondence: Classification of Assets

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CLASSIFICATION OF ASSETS

EDITOR, THE JOURNAL OF ACCOUNTANCY:

SIR: I have just read the letter of Maurice E. Peloubet which appeared in the October issue of THE JOURNAL. In it he refers to theories which, if I remember correctly, were set forth more completely in an address before the Institute meeting at Colorado Springs in the fall of 1930. Incidentally he refers to an article by me which appeared in the January, 1932, issue and indicates disappointment at my general support of the present form of balance-sheet. Because of this reference and because the theories which Mr. Peloubet so ably argues are of a character that invites discussion, I am taking the liberty of discussing the subject of his letter and of disagreeing with many of his views, with the hope that still further discussion will be developed.

As I understand Mr. Peloubet, he believes that the generally accepted form of balance-sheet presentation of the financial status of an enterprise should be modified so as to divide the cash, accounts receivable and other circulating assets as between those which are normal or necessarily of permanent investment in a going enterprise and those which, because in excess of the normal requirement, are available for withdrawal and distribution to the stockholders. He maintains that the present division between fixed and current assets is illogical and at times misleading and takes the view that such a distinction is forced upon accountants by the insistence of the banker in looking at an enterprise from the standpoint of liquidation rather than from the standpoint of a going concern. As he later states that it is logical to separate assets as between fixed and circulating—but objects to the assumption that circulating assets do not represent capital which is just as much invested in the business as the plant assets—I must conclude that Mr. Peloubet favors a balance-sheet in which the primary division of assets would be between those which represent the amount of capital necessarily invested in the business and those which were free to be distributed to stockholders or were available for liquidation of liabilities.

I find Mr. Peloubet's theories most interesting but I can not agree that, except in specific instances, they are practicable of application, nor can I support his statement that the present balance-sheet division between fixed and current assets is "thoroughly illogical."

A balance-sheet to my mind is intended to present the financial status of an enterprise as a going concern, reflecting the manner in which its capital has been invested. I find the present balance-sheet practice generally satisfactory for this purpose. To attempt to show separately those assets which are available for distribution and those which are necessarily of retention would lead to such uncertainty as to defeat its purpose. The accountant would find more difficulty in determining which assets were necessary and which were unnecessary in the conduct of a business than he has at present, upon occasions, in determining which should be classed as current and which as non-current. It would be rare that the view of the accountant and the view of the client would agree. The extent of cash or of outstanding accounts receivable or of inventories which are necessary to the conduct of a business will vary materially with changes of price levels, credit terms, sales volume and prospective conditions. In this period of depressed prices and contracted volume there are many enterprises which have a clear surplus of circulating assets which, if present conditions were to continue, would be susceptible of distribution to the stockholders, but as the depression passes and sales volume and price levels increase these apparently surplus funds will gradually become required again. The proportion of circulating assets which should be financed by current debt varies with different classes of business and is frequently a matter of administrative policy. Would the accountant be justified in insisting that a portion of a cash balance be ear-marked as available for distribution merely because the ratio of working assets over current liabilities was excessive in his opinion? I think not. There are many instances, of course, where the existence of assets which are not or will not normally be required by the business is clearly evident and in such cases there could be no objection to their separate exhibition.

It is fundamental, I think, that all capital which is essential to the operation of a business is invested in two things—one, those facilities necessary to the conduct of the business or fixed properties and, second, that property in which, as opposed to with which, the enterprise deals, which (items such as cash, accounts receivable and inventories) is necessary to the circulation essential to the operating cycle. These two characters of assets, fixed and circulating, or fixed and working, I believe are wholly appropriate for segregation. To my mind, and I again refer to my article in the January JOURNAL, the terms current assets and working assets should practically be synonymous, and if this view is taken, then the comparison between current assets and current liabilities will develop the amount of the capital of the enterprise which is invested in operating net assets and the amount invested in fixed properties. I agree that current assets, because of the insistence of bankers, frequently include items which should be excluded, because, while realizable, they do not represent circulating property, and on the other hand that bankers have caused the exclusion from the caption of several items which should be included because, while admittedly without immediate liquidation value, they represent circulating property and are actually realizable through a continuance of operations.

It is not the purpose of a balance-sheet to inform the stockholder of the amount which he might expect from liquidation nor of the amount which he may argue should be distributed. The first is not contemplated and the second is a matter of administrative policy. It is not even intended, except in rare instances, to inform him what his stock is intrinsically worth. It is intended, to my mind, to inform him of the manner in which the capital of the enterprise has been invested so that he may use such information combined with other factors in reaching an opinion of the financial stability and prospective income and dividend capacity of the enterprise. An important factor in such a determination is the proportion of the total capital which is invested in net working assets (working capital) and the proportion of the total working assets financed through current debt. To exhibit this information, the present form of balance-sheet, with some modifications which I have suggested, seems to me wholly satisfactory, although I again record my agreement with the thought that assets, be they current or fixed, which are clearly surplus for present or prospective requirements of the business, may with propriety, and sometimes should be, separately classified.

I question whether the present form of balance-sheet has been forced upon accountants because of the tendency of bankers to value an enterprise upon a liquidation rather than a going-concern basis. I do think certain of our practices with respect to what should and should not be included in current assets have been created by the insistence of bankers and that many of such practices are not sound. Surrender value of life-insurance policies is certainly not a circulating asset and the value is not realizable without the loss of something to the business, but nevertheless bankers will strongly argue that such value is a current asset because immediately realizable. The same theory would justify the inclusion within current assets of a portion of the plant value because it represented the amount that could be quickly realized through mortgage. On the other hand prepaid rent is clearly realizable through current operations and its proper position as a circulating or current asset should be clear, notwithstanding that it is not available for the immediate liquidation of a creditor's account.

While I can not subscribe to much that Mr. Peloubet advances, I nevertheless believe that in presenting such theories for discussion he is making a real contribution to accountancy. It is only by discussion of such subjects that we advance.

Faithfully yours,

ANSON HERRICK.

San Francisco, October 11, 1932.